

***United States Court of Appeals
for the Second Circuit***



**APPELLANT'S
BRIEF**

ORIGINAL

77-5034

United States Court of Appeals
For the Second Circuit

In re APPLIED LOGIC CORPORATION,

Bankrupt.

NEW JERSEY NATIONAL BANK,

Plaintiff-Appellant.

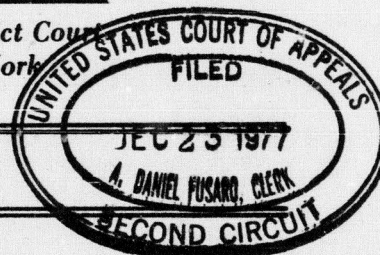
-against-

DANIEL GUTTERMAN as Trustee of
APPLIED LOGIC CORPORATION, Bankrupt,

Defendant-Appellee.

*On appeal from the United States District Court
for the Southern District of New York*

APPELLANT'S BRIEF



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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

Docket No. 77-5034

In re

APPLIED LOGIC CORPORATION,
Bankrupt.

NEW JERSEY NATIONAL BANK,
Plaintiff-Appellant,

-against-

DANIEL GUTTERMAN as Trustee of
APPLIED LOGIC CORPORATION,
Bankrupt.

Defendant-Appellee.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE SOUTHERN DISTRICT OF NEW YORK

APPELLANT'S BRIEF

INTRODUCTORY STATEMENT

This appeal involves the propriety of the exercise by appellant, New Jersey National Bank ("Bank"), of its traditional contractual right to set off monies of the now bankrupt Applied Logic Corporation ("ALC") deposited with it. The actual set offs took place both before and after ALC filed a

petition for an arrangement under Chapter XI of the Bankruptcy Act. Bank is appealing from the order and decision of Bankruptcy Judge Roy Babitt, affirmed by District Court Judge Gerald L. Goettel, which held that equitable principles of estoppel require Bank to repay to the trustee-defendant all monies set off by it.

STATEMENT OF ISSUES PRESENTED FOR REVIEW

1. Whether the courts below erred in finding that Bank misrepresented to other creditors the true nature of the Account and of Bank's intention to utilize its set off right where ALC or defendant produced no creditor at trial to testify about Bank's alleged misrepresentations and the only testimony related to this issue conclusively shows the absence of any misrepresentation.

2. Whether the courts below erred in failing to apply this Circuit's rule, recently reaffirmed in Katz v. Glen Head National Bank (76-7577), by denying Bank's set off right in the absence of findings that ALC's Account was not maintained in good faith and in the regular course of the business of the bankrupt and the bank but instead found that Bank's set off right was inconsistent with the

"spirit" of previous refinancing agreements between Bank and ALC.

3. Whether the courts below erred in failing to consider the adverse ramifications to the willingness of future lenders to enter into workout refinancing agreements with debtors by denying Bank the set off rights it had under its refinancing agreements.

4. Whether the courts below erred in not permitting Bank to apply money and certificates of deposit in which Bank had a perfected possessing security interest, to satisfy a \$100,000.00 loan secured by all of ALC's "unencumbered assets," where counsel for ALC conceded at trial that Bank was at least entitled to the \$100,000.00 in satisfaction of that loan.

5. Whether Bank was denied procedural due process when ALC never gave notice of any kind that a cause of action based on estoppel would be asserted, when the only testimony arguably related to that issue came up on the cross-examination of the last witness at the end of the trial.

6. Whether the order of the bankruptcy court below, dated March 1, 1977, conforms with its memorandum opinion dated December 9, 1976.

PROCEEDINGS BELOW

On March 27, 1975, ALC filed a petition for an arrangement under Chapter XI of the Bankruptcy Act.

On August 10, 1976, ALC was adjudicated a bankrupt and Daniel A. Guttermann ("defendant") was appointed trustee. (A-461).

On April 19, 1975, Bank commenced an adversary proceeding pursuant to Part XII of the Rules of Bankruptcy Procedure, 411 U.S. 1068, et seq., against ALC seeking, in part, the determination of the validity of a security interest in certain of ALC's assets and for other and further relief, including turnover by ALC of the collateral subject to the security interest of Bank. ("Complaint"). (A-20).

On or about April 30, 1975, ALC filed an answer and counterclaims and thereafter, by leave of court, an amended answer with counterclaims dated June 10, 1976. (A-83).

The counterclaims raised by ALC and adopted by defendant assert causes of action against plaintiff based on Sections 60 and 67d(2) of the Bankruptcy Act. (A-86, 87).

On or about June 21, 1976, Bank served and filed an "answer to amended counterclaims" which raised various affirmative defenses and moved, pursuant to Bankruptcy Rule 712, for an order dismissing the counterclaims and for judgment in its favor. (A-94).

On June 23, 1976, a non-jury trial was held before Bankruptcy Judge Roy Babitt. The parties stipulated to include a part of the record the transcript of the proceedings held before retired Bankruptcy Judge Asa S. Herzog, on June 16 and July 24, 1975, as well as the exhibits introduced in evidence at the proceedings before Judge Herzog. (A-214).

On August 10, 1976, following the trial of the issues raised by the pleadings herein, and before the bankruptcy court rendered its decision, ALC was adjudicated a bankrupt, and defendant was appointed trustee. (A-461). While no formal order has been entered substituting him for ALC, the parties and the courts below have both considered him to be the real party in interest, the debtor-in-possession having ceased to exist as legal entity. The written decision and judgment of Judge Babitt dated December 9, 1976, reflects that the defendant has adopted and continued and is bound by the litigation sub judice. (A-464).

On March 1, 1977, the bankruptcy court entered an order granting the defendant judgment in the amount of \$235,337.54, with interest, upon all of the counterclaims interposed by ALC and granted Bank a money judgment in the amount of \$40,000.00. (A-479).

On March 11, 1977, Judge Babitt entered an order extending the time for appellant to appeal to and including March 31, 1977 and on March 31, 1977, appellant filed its Notice of Appeal to the District Court. (A-485).

On October 14, 1977, District Court Judge Goettel rendered an opinion affirming the bankruptcy court's order. (A-492).

On November 14, 1977, Bank filed its Notice of Appeal to this Court. (A-508).

THE BANKRUPTCY JUDGE'S DECISION

Bankruptcy Judge Babitt rendered a written memorandum opinion and decision dated December 9, 1976. (A-463). The memorandum decision does not contain separate findings of fact.

The Bankruptcy Judge held that defendant was entitled to judgment on the theory of an equitable estoppel, finding that Bank had represented to creditors that it could not assert a right of set off and further finding that "the other creditors relied and changed their position to their detriment." (A-477). The court made no findings of fact with respect to reliance or with respect to detriment to creditors caused by the alleged reliance. No creditor testified at the trial.

The pleadings made no reference to a cause of action based on estoppel, and gave no notice that such a theory would be relied upon. (A-83=90).

BACKGROUND

Opening of the Account

In approximately April 1968, ALC opened a demand checking account with Bank and was given a \$100,000.00 line of credit.^{1/} The checking account, number "320589," was unrestricted and for the general use of ALC. This is the account referred to throughout all of the testimony, and shall be referred to hereafter as the "Account." (A-342=344, A-21).

From its inception in 1968, through 1970, the Account was used on a regular basis for withdrawals and deposits. (A-128).

Bank provided usual banking services to ALC, including loans, banking advice, letter of credit facilities, credit checking and the like. (A-346). During the period 1968 through 1970, ALC also had banking relationships with other banks. (A-127). In September, 1970, ALC was indebted to the Bank in the principal sum of \$650,000.00; to First National Bank of Princeton in the sum of \$300,000.00; to Chase Manhattan Bank in the sum of \$250,000.00; and to First National City Bank in the sum of \$100,000.00, for a total principal indebtedness to all banks in the amount of \$1,300,000.00. (A-408).

^{1/} ALC was in the computer time sharing business, owning computers and leasing their time to its customers.

Negotiations Between ALC
And Its Creditors

Sometime in mid-1970, Martin Mobach ("Mobach") personally contacted certain major creditors, including Bank and major equipment lessors, regarding the financial problems of ALC. (A-199,100). Mobach was Vice President of marketing of ALC. (A-284).

After this first contact with creditors, it was suggested that a joint meeting between the equipment lessors and the banks to which ALC owed money should be held to further discuss the financial affairs of ALC. (A-198, 199). At the time of these discussions ALC was obligated to make monthly rental payments to equipment lessors in the approximate amount of \$161,000.00 and was in arrears on lease rental payments in an amount in excess of two million dollars. (A-433).

The 1970 Agreement

After fairly lengthy discussions with certain of its creditors, a written agreement was reached, which was dated and executed on September 2, 1970. (A-404). The parties to the 1970 Agreement were: ALC, Bank, Chase Manhattan Bank, First National Bank of Princeton, and six equipment leasing companies, including CIT Leasing Corp., Boston Leasing Corporation and Digital Equipment Corp. (A-404). At the time

of the 1970 Agreement ALC was indebted to each of the parties in substantial amounts. (A-404).

The purpose of the 1970 Agreement was to reschedule the terms of payment so that the trade creditors would be paid 100 cents on the dollar and ALC would continue in business. (A-185). As a result of the 1970 Agreement and the subsequent 1971 Agreement, all the trade creditors, employees and taxes were fully paid prior to the filing of ALC's Chapter XI petition. (A-156). The 1970 Agreement also provided for making new funds available to ALC. (A-412). The 1970 Agreement also recited that the total amount of indebtedness of ALC to the creditor banks was the sum of \$1,300,000.00, (A-418) of which \$650,000.00 was owed to Bank. (A-118).

By the terms of Paragraph "2" of the 1970 Agreement, the several notes representing indebtedness to the creditor banks were converted into two notes, both payable to Bank, one in the amount of \$1,000,000.00, "which shall be held by New Jersey National Bank on behalf of the other Banks" and the other on behalf of First National Bank of Princeton for \$300,000.00. (A-408).

ALC agreed to "conduct all banking of its funds at and through New Jersey National Bank until both notes are paid." (Emphasis added). (A-409). The 1970 Agreement provides further that except for the forbearance by the

banks to demand payment on the past due notes "all other terms and conditions of said notes shall remain in force without alteration." (A-409).

The 1970 Agreement also provided that the parties would extend to ALC an irrevocable line of credit in the amount of \$750,000.00. The other banks which were parties to the 1970 Agreement (other than First National of Princeton) agreed to participate in the line of credit with Bank in proportion equal to each bank's relative share of the \$1,000,000.00 note." (A-412).

As a condition precedent to drawing on the irrevocable line of credit, ALC was required to raise at least \$300,000.00 by September 14, 1970, through the sale of convertible notes. (A-419). The 1970 Agreement specifically requires that the \$300,000.00 was to be used by ALC "in the ordinary course of business and in payment of \$100,000 [sic] loaned to ALC by New Jersey National Bank on August 28, 1970." (Emphasis added). (A-412).

With respect to loans made against the line of credit available under the 1970 Agreement, it was agreed that the loans would be secured as follows:

1. \$350,000.00 in the form of a security interest in certain computer equipment; (A-413)
2. \$225,000.00 by a pledge of marketable securities worth at least \$300,000.00; (A-416)

3. \$75,000.00 in the form of collateralized personal guarantees to be given by officers, directors and/or key employees of ALC; (A-416)

4. \$100,000.00 in the form of a security interest in all unencumbered assets other than the computer equipment mentioned in "1" above; and (A-417)

5. "Such other collateral as may be necessary." (A-417).

The 1970 Agreement establishes a "Committee" of certain named creditors and provides that the Committee, through its authorized representatives, shall have complete access to all books and records of ALC, including meetings of directors and committees. (A-422, 423). ALC was required to report to the Committee with respect to its business and operations, including projections of future operations. (A-422, 423). Specified officers of ALC were to "make themselves available to the Committee and to each member thereof to discuss any aspect of the business and operations of ALC at all reasonable times." (A-423).

The 1970 Agreement also requires ALC to make monthly reports to each member of the Committee. The reports were to set forth cash receipts, cash expenditures and operating revenues. (A-423, 424).

Paragraph 7(a) of the 1970 Agreement provides that the agreement may be terminated by written notice by

any member of the Committee to the other parties to the 1970 Agreement if certain future conditions are not met by ALC. (A-424-427). The conditions under which a member of the Committee could act to terminate the Agreement included certain minimum future operating revenues of ALC. (A-424).

Under certain other described circumstances, any three members of the Committee were given the right to terminate the 1970 Agreement. (A-425).

The 1970 Agreement automatically terminated upon the institution of any reorganization or bankruptcy proceeding. (A-428). Upon default in payment or other substantial and material default, any party had the right to terminate the Agreement by written notice to the other parties. (A-428, 429). The 1970 Agreement was to be governed by the laws of the State of New Jersey. (A-430).

Relationship of ALC With
Bank After 1970 Agreement

From and after September, 1970, ALC conducted most of its banking activities at Bank using the same Account which existed prior to the 1970 Agreement. (A-288-290).

For example, the Account was used to transfer funds to First National Bank of Princeton to pay payroll, and was used to pay fuel and utility bills and accounts

payable. (A-288, 289). Checks drawn and honored to pay approximately 272 trade creditors of ALC through the Account. (A-156, 157, 185). With the exception of payroll payments, all other payments by ALC were through the Account at Bank.

Checks were drawn on the Account and honored without prior approval by Bank. (A-244).

In May, 1971, ALC took advantage of the irrevocable line of credit by borrowing \$100,000.00 from Bank. The loan is evidenced by a demand note (" \$100,000 Note") payable to Bank (A-26-30) and a security agreement specifying collateral as being all unencumbered assets, including all inventory, all accounts and all notes receivable. (A-31-37).^{2/} The Bank's security interest was duly perfected by the filing of requisite U.C.C. financing statements in May and June 1971 (A-378-389) and by the possession of monies on deposit in the Account. (A-317).

The \$100,000.00 Note contained the following provisions applicable to the Bank's right of set off:

"And the holder hereof is hereby given the further right to demand additional collateral security from time to time, whether or not this or any other obligation of the undersigned, or any of them, is due, and if the undersigned shall not on demand furnish such further security, or

^{2/} This loan was the subject of the Bank's complaint sub judice.

if the principal or interest upon this or any of the obligations of the undersigned or any of them to the holder hereof be not paid when due, or if any party to this note shall die or become insolvent, thereupon upon the happening of any of the foregoing events, at the option of the holder, this and any or all of said obligations of the undersigned shall become and be due and payable forthwith without presentation, demand, notice, protest, notice of protest or other notice of dishonor of any kind, all of which are hereby expressly waived; and the holder of this note, or any officer or agent of the holder, is empowered to retain and apply any money, securities or property of any kind belonging to the undersigned, or any of them, to the payment of this or any other obligation of the undersigned, or any of them, and to sell at public or private sale, at any Broker's Board, Public Exchange or elsewhere, assign and deliver, (and at the option of the holder, by suit or otherwise, to collect, receive, payment for, surrender, indorse for cancellation, compromise, release, renew, extend, exchange or substitute) the whole or any part of the collateral, and all additions and substitutions thereof, including notes and all negotiable instruments, bonds or notes secured by mortgages or other choses in action, or promises or agreements of any character to pay money, without advertisement or notice to any party to this note of the time or place of sale, or of any adjournment thereof." (Emphasis Added). (A-27).

It is expressly provided in the note that:

"No delay by the holder hereof in exercising any power or right hereunder shall operate as a waiver thereof" (A-27).

At the time of trial, the balance due to Bank represented by that secured note had been reduced to \$58,153.44, because credit had been given on the principal of the loan for monies of ALC which had been set off by Bank and applied against the \$100,000.00 Note. (A-110). The effect of the order of the bankruptcy court below is to increase the balance

due on the secured loan to \$100,000.00 plus interest thereon. This loan is, by its terms, secured by all unencumbered assets which would include any monies or instruments such as certificates of deposit of ALC on deposit at Bank. (A-32, 417).

The 1971 Agreement

On September 15, 1971, ALC entered into a written "Recapitalization Agreement" (the "1971 Agreement") with the parties to the 1970 Agreement, plus Bryant Computer Products. (A-61=82). The signatories were due an aggregate of \$10,863,533.61, which included outstanding indebtedness and all future rents to become due under equipment leases to the signatory equipment leasing creditors. (A-80).

The 1971 Agreement states that the parties desire to provide for the payment of the indebtedness due them prior to the 1970 Agreement by substituting the provisions of the 1971 Agreement for the terms of the 1970 Agreement, "which is hereby amended." (A-62). The 1971 Agreement also provides that except for the changes expressly made by it, the 1970 Agreement shall remain in full force and effect. (A-69).

By its terms, the 1971 Agreement gave rise to a forgiveness of 50% of ALC's pre-1970 obligations to the signatory creditors in exchange for certain subordinated securities. (A-66). Thus, the original (pre-1970 Agreement) debt to Bank was reduced from \$650,000.00 to \$325,000.00. The \$100,000.00 secured debt, representing part of the line of credit, was not forgiven to any extent. (A-69, 70).

Paragraph "4" of the 1971 Agreement provides for reduction of indebtedness; the amount of indebtedness due to the respective banks after the reduction is referred to as "Close Out Debt." (A-66).

References to the "Guaranteed Bank Loan" in the 1971 Agreement refer to the \$750,000.00 secured loan to ALC pursuant to the line of credit established by the 1970 Agreement. (A-63). Paragraph "7" provides that interest on the Guaranteed Bank Loan is payable monthly at the prime rate. (A-69).

Under the 1971 Agreement the principal of the Guaranteed Bank Loan would be reduced only when ALC had a "positive cash flow," defined by that Agreement to mean the "excess of ALC's cash receipts over cash expenditures." (A-63). Payments of positive cash flow to reduce principal are governed by ¶ "8" of the 1971 Agreement which basically provided that 50% of the positive cash flow would be paid by ALC to a "special account maintained with the New Jersey National Bank." (A-69). Paragraph "8" also required that the positive cash flow so deposited "shall be used by ALC within ten days after deposit to pay the principal of the Close Out Debt" in accordance with certain priorities. (A-69). It was specifically provided that "all interest on [sic] the account will belong to ALC." (A-71).

The continuing validity of the security interests of the creditor parties to the 1970 and 1971 Agreement is mandated by Paragraph "11" which provides that:

"Nothing contained in this Agreement [the 1971 Agreement] or the Financing Agreement [the 1970 Agreement] is intended to affect any security interest held by any Bank or Lessor. ALC agrees to perform all obligations of ALC to the Banks pursuant to their respective notes, loan arrangements and security agreements." (A-72)

The 1971 Agreement provided for the election to ALC's board of directors of representatives of certain parties to that agreement. (A-74, 75). An officer of the Bank was designated by the other banks and, together with four other representatives, was elected to the board of directors of ALC in 1971. (A-154, 155).

Paragraph "17" of the 1971 Agreement designates the circumstances under which any party to the Agreement could declare their debt or note to be immediately due and payable. (A-76, 77).

As a result of the 1970 and 1971 Agreements, all the trade creditors, employees and taxes were paid "100 cents on the dollar." (A-156, 185).

Reporting to Creditors by ALC
Under the 1970 and 1971 Agreements

ALC was to report to the "Committee" formed pursuant to the 1970 Agreement regarding all respects of the business and operations of ALC. (A-422, 423). Under the 1971 Agreement ALC also agreed to send all of the banks "a current aging [sic] of its Accounts Receivable." (A-70). This was done because the "Accounts Receivable were then and thereafter remained 'partial security' for the Bank loan. (A-70).

ALC provided a summary of receipts and disbursements and other financial statements to all the parties to the 1971 Agreement. (A-75). In addition, the "Committee" under the 1970 Agreement was given "all material information concerning the financial

condition and business prospects" of ALC. (A-75).

Monies Deposited with Bank

After execution of the 1971 Agreement and pursuant to the terms of the 1970 Agreement ALC deposited all of its receipts with Bank. (A-311).^{3/} These receipts were deposited in the general Account. As receipts accumulated large accumulations were then used, in part, to purchase certificates of deposit ("Certificates"). (A-243). These certificates were usually in the amount of \$100,000.00 each. (A-243). The first certificate was purchased in January 1972. (A-390). ALC's witness Mobach sought to convey the impression that only so called "working capital" funds had been transferred to certificates. (A-257). This was a physical impossibility because all monies raised by ALC were commingled in the general Account with all other receipts of ALC. (A-311).

Procedure for Purchasing Certificates of Deposit

From the inception of its banking relationship with ALC, Bank had provided customary banking services, including investment advice. As ALC began to accumulate funds in the Account a decision was made by ALC to purchase

^{3/} At one point Mobach had testified that the monies deposited represented identifiable "working capital" raised pursuant to the 1971 Agreement. He recanted his direct testimony on cross-examination. Likewise, the funds of ALC placed in certificates of deposit represented a commingling of the general receipts of ALC. No attempt was made to identify and trace those monies raised through the sale of equity in ALC. (A-188).

certificates in order to generate additional income to ALC in the form of interest. Bank supplied ALC with current information as to interest rates and terms; generally, ALC selected the term yielding maximum interest. (A-315, 316). ALC did not take physical possession of the certificates but left these certificates with Bank. (A-316, 317). Bank notified ALC as each certificate came due. When each certificate matured, Bank credited the ALC Account. The Account would be debited upon instructions of ALC to purchase a new certificate. (A-131, 347). Generally the transfer in and out of the Account was simultaneous. (A-131, 347).

From 1972 through 1974 the amount of funds in certificates varied substantially, depending on the business needs of ALC. (A-131). The complete record of certificates purchased by ALC is reflected in Exhibit "4" in evidence. (A-390)

Operation of Bank Account
From 1970 Through July 1974

Throughout the trial, ALC's only witness, Mobach, attempted to convey the impression that Bank acted in some "custodial capacity" and "monitored" the Account and that this so called monitoring was required by the terms of the 1970

and 1971 Agreement.^{4/} The facts are otherwise.

Lynch, the officer of Bank in charge of the ALC Account, testified that the Account was the usual type of unrestricted general business demand account and was not controlled by Bank. (A-354). Counsel for ALC admitted that the account was a "general checking account." (A-147). The only restrictions on the Account were those normally incident to the maintenance of a general business account such as drawing checks against uncollected funds or where the Account was otherwise overdrawn. (A-352). Pursuant to the terms of the 1970 Agreement Bank also refused to permit ALC to transfer funds to other banks. (A-151). When this was done an officer of ALC was advised of the reason for not permitting the transfer. (A-151).

From the general receipts initially deposited in the Account by ALC, approximately \$200,000.00 was used by ALC in its operations between 1971 and 1974. (A-262). These funds were required because the accounts receivable of ALC were collected more slowly than had been anticipated. (A-193). An unspecified portion of the \$200,000.00 represented funds from certificates that had matured, and had then been

^{4/} As Judge Herzog observed, it was Mobach's personal construction of the agreements which formed the basis for his testimony. (A-181). The witness agreed with this description of his testimony. (A-126). Mobach was, of course, unable to point to any provision of the agreements which support his characterizations. (A-180).

deposited in the Account and withdrawn by ALC for use in its business rather than being reinvested by ALC. (A-262).

The Special Account

While the 1971 Agreement called for a "special account" to be established for the receipt of payments from ALC to be used to pay the principal of the Close Out Debt, such an account was not established. (A-147). The alternative procedure adopted by the Board of Directors authorized payments by ALC directly to creditors, "to expedite receipt by individual parties." (A-395). The only evidence offered at trial was that ALC had made payments to creditors out of the "positive cash flow." (A-147, 237, 238). ALC presented no evidence to show that any of the monies remaining in Bank's possession by reason of its exercise of the right of set off represented deposits of "positive cash flow" originally intended for the special account. In fact, a reasonable inference would be that none of the purported deposits of "positive cash flow" remained in the Account because the 1971 Agreement specifically required that the funds so deposited be disbursed by ALC within 10 days. (A-69).

Acceleration of Indebtedness Due
Bank and Set off

In June 1974, the creditors and parties to the agreements were advised that ALC would be unable to meet the "positive operational cash flow" requirements of the 1971 Agreement. (A-157).

It was at this time that ALC sought to withdraw \$100,000.00 for "payroll" (A-152), Bank accelerated the entire debt due it. The actual acceleration of Bank was done by letter dated July 3, 1974 in which Bank notified ALC that ALC was in default in breach of the 1971 Agreement (A-158) and that accordingly, Bank was accelerating all debt due it.

After acceleration, Bank advised ALC of its intent to apply funds in the Account against the debt due to Bank. ALC requested Bank not to take such action at that time. (A-354). Bank agreed to refrain from actually offsetting the monies, provided that ALC maintained funds on deposit with Bank at the then existing level. (A-355). In order to prevent diversion of funds, Bank thereafter reviewed all checks drawn on the Account. (A-354).

Issuance of Irrevocable Letter of
Credit by Bank and Assignment of
Certificate of Deposit

The court below omitted to make any finding of fact with respect to the entire transaction described below.

In 1973 ALC was confronted with a State of New Jersey tax claim. ALC was required to post collateral security while it was litigating the claim. (A-153). The premium for such a bond was extremely expensive and ALC, through Mobach, consulted Lynch as to other alternatives. (A-153, 197, 264). Lynch recommended that a letter of credit be posted as security. (A-264). ALC consulted with its legal counsel and thereafter requested that Bank issue an irrevocable letter of credit. (A-153, 264, 265). In order to issue such irrevocable letter of credit Bank required collateral. A certificate, #240390, in the amount of \$100,000.00 was then specifically assigned to Bank by ALC. (A-347, 348). The written instrument of assignment was executed by Mobach on behalf of ALC. (A-264, 265). Mobach was familiar with the form of the assignment and his signature was witnessed by counsel to ALC. (A-263, 266).

The assignment, dated November 1, 1974, provides in its first paragraph that the certificate is sold, assigned and transferred to Bank as security for a loan of \$60,000.00. (A-399).

The second paragraph of the assignment provides that:

"This assignment shall be a continuing one . . . ; and shall also operate as security for payment of any other debts or liabilities, either directly or indirectly, of the undersigned to New Jersey National Bank now in existing or hereafter contracted.

New Jersey National Bank is hereby authorized to charge against the above savings account, any note or notes representing unpaid balance of above loans at maturity, thereafter or otherwise, and any other debts or liabilities, either directly or indirectly of the undersigned"

(Emphasis supplied). (A-399).

After the assignment, Bank maintained control over the certificate, renewed it from time to time, but did not make any transfer into the general Account of ALC as had been done with the other certificates. (A-348). This certificate continued to be held in the name of ALC. (A-367).

A portion of this certificate was set off in December 1974, and a balance in the amount of \$60,000.00 was maintained, that amount being equal to the liability on the letter of credit. (A-349, 350).

On March 30, 1976, after the litigation with the State of New Jersey was concluded, Bank redeemed the certificate. The sum of \$33,904.24 was used to purchase a cashier's check payable to the State of New Jersey, Department of Treasury, Division of Taxation. The sum of \$26,095.76, together with \$2,952.07 in interest, was applied by Bank against ALC's debt to Bank. (A-274, 350).

Other Set-offs

During June 1974, Bank notified other parties in interest that it was terminating its loan of \$325,000.00. (A-157, 158).

On December 3, 9 and 31, 1974, Bank actually exercised the right of set off by applying monies on deposit in certificates in the respective amounts of \$100,739.58, \$101,551.11 and \$41,485.42 against the balance due on the unsecured loan. (A-116, 91).

In April 1975, Bank applied funds of ALC held by Bank in the respective amounts of \$1,682.98 and \$830.62 against the loan balance. (A-92, 93, 140).

ARGUMENT

POINT I

BANK NEVER MISREPRESENTED TO OTHER
CREDITORS THE TRUE NATURE OF THE
ACCOUNT AND ITS INTENTION TO
EXERCISE ITS RIGHT OF SET OFF

The courts below based their decisions on the concept of equitable estoppel. (A-477); (A-498).

Thus, the bankruptcy court below held that Bank:

"[C]onfronted with the apprehensions of the other creditor banks that the depository bank could assert a right of set off, represented that it would not be in a position to do so." (A-477)

ALC produced no creditors at trial who testified that Bank ever made such a misrepresentation. The testimony of Lynch, Bank's vice president, the only evidence on the issue of misrepresentation adduced at trial, (A-371,372), shows that: (a) all the other creditors who participated in the 1970 Agreement ("1970 Agreement Creditors") which created the Account understood that the Account was general in nature; (b) some of those creditors were concerned that Bank would set off the funds on deposit in the Account; and (c) Lynch allayed those fears not by

representing that the Account was special in nature and not subject to set off, but by explaining that if the 1970 Agreement was executed and implemented and the notes provided for thereunder or pursuant to any other agreement were not in default, Bank could not set off since no indebtedness would be due Bank. (A-371-372). Thus, Lynch's testimony reads as follows:

"Q. (Lebow) [Counsel] for ALC You were ready to clarify the subject of set off. You were stopped. Is there anything that you want to....

'A. (Lynch) I think there was a discussion. It is a little fuzzy. I think the concern evidenced by some of the other creditors was that the additional capital would be deposited in the Bank. The capital that was required under the agreement and the day after it was deposited it would be set off. I told them that "if the agreement was put together and signed and if we didn't have a past due note at that time, we had no way to set off. So whether we wanted to or not we couldn't." (Emphasis added)

'A. (Mr. Lebow) I have no further questions.'" (A-371, 372).

There was no testimony or evidence adduced that showed that Lynch ever represented that Bank would never

assert its right of set off if any notes were in default, only that Bank could not assert its set off right against the general Account as long as ALC did not default on notes due under the 1970 Agreement or otherwise, because no indebtedness would be due against which set off could be exercised. (A-372).

In holding that Bank represented to other 1970 Agreement creditors that Bank "would never" exercise its set off right on the funds deposited in the Account, the courts below completely read out the underlined portion of Lynch's testimony. (A-477); (A-498).^{5/} The holding of the bankruptcy court below is clearly erroneous. Bankruptcy Rule 752.

Moreover, the finding of the bankruptcy court below is totally inconsistent with the 1970 Agreement itself. That Agreement specifically gave any party the right to terminate the Agreement upon default in payment. (A-428, 429). Clearly, Bank never waived its right to terminate the Agreement upon a default and exercise whatever rights it had.

^{5/} See, e.g., the statement of Judge Goettel, at pp. 6-7 of his opinion to the effect that:

"The uncontradicted evidence established that NJNB played a major role in formulating the two refinancing agreements and that it closely monitored the financial status of ALC through its representation on the board. Moreover, Judge Babitt found that defendant's other creditors had relied upon plaintiff's assurances that NJNB would not exercise its right to set-off. This reliance resulted in their maintaining the status quo established by the refinancing agreements and foregoing, to their detriment, alternate procedures to improve their own claims."

ARGUMENTPOINT I

THE HOLDING OF DUDLEY IS FACTUALLY DISTINGUISHABLE FROM THIS CASE AND SUBSTANTIVELY IN CONFLICT WITH THE TRADITIONAL RULE OF THIS CIRCUIT REAFFIRMED IN KATZ v. GLEN HEAD NATIONAL BANK WHICH PERMITS A BANK TO EXERCISE ITS SET OFF RIGHT AGAINST AN ACCOUNT IN THE ABSENCE OF A FINDING THAT THE ACCOUNT WAS NOT MAINTAINED IN GOOD FAITH AND IN THE REGULAR COURSE OF THE BUSINESS OF THE BANKRUPT AND THE BANK.

A.

Waiver by Bank of its right to set off the Account requires proof establishing an "intentional relinquishment...of a known right." Johnson v. Zerbst, 304 U.S. 458 (1938); First National Bank of Portland v. Dudley, 231 F.2d 396 (9th Cir. 1956).

Every presumption against waiver is indulged. U.S. ex rel. Turner v. Rundle, 438 F.2d 839 (3rd Cir. 1971); Lavalles v. Estelle, 370 F.Supp. 238, aff'd, 500 F.2d 1182 (5th Cir. 1974).

Bank never intentionally relinquished its right to set off in the 1970 Agreement. To the contrary, the 1970 Agreement specifically provided for the maintenance of the Account. (A-409). The 1970 Agreement Creditors understood the Account was subject to set off and discussed the issue with Bank's representative. (A-371,372).

The facts in the Dudley case, principally relied upon by the courts below, are completely inapposite.

In Dudley, supra, the court found an intentional relinquishment and estoppel by the bank of its set off right because of its agreement with other creditors to commit all the proceeds resulting from the liquidation of the bankrupt's inventory towards payment of all claims on an equal and ratable basis, without reserving its right to set off of proceeds deposited in the Bank's general account. Id., at 400.

Unlike Dudley, the Bank specifically reserved its right to set off. The \$100,000.00 demand note executed by ALC in May 1971 specifically empowered Bank to retain and apply any money, securities or property of any kind belonging to ALC, for the payment of the \$100,000.00 loan or any other obligation to ALC. (A-27). The 1971 Agreement, executed by all the same creditors who were parties to the 1970 Agreement, specifically reaffirmed ALC's continuing obligation to perform all terms and conditions of all outstanding notes, loan arrangements and security agreements. (A-72).

Moreover, in Dudley, the agreement there made no provision for depositing the proceeds of the inventory sales in the general account maintained by the bankrupt at the bank prior to the execution of the agreement. Rather, the court presumed that the bankrupt deposited all the proceeds in its general account with bank in the ordinary course of business as had been the case prior to the agreement. Id., at 400. The trade creditors, having been told by the bank that all proceeds would be applied to all claims on a pro rata basis and these creditors, not having been apprised in the agreement that all such funds were being placed in an account subject to the bank's right of set off, properly contended and were upheld in their view that the bank intentionally waived or was estopped from asserting its right of set off. Id., at 402.

In contrast, in the matter, sub judice, no representations were made that all the proceeds of the Account would be applied on a pro rata basis to all 1970 Agreement Creditors. The 1970 Agreement clearly differentiated between ALC's obligation to maintain the Account with Bank and its repayment obligations to 1970 Agreement Creditors.

(A-409). The Bank's set off rights and intentions were considered and discussed. (A-371, 372). The factual circumstances of this matter are completely different from those faced by the court in Dudley, principally relied upon by the courts below.

B.

The improper reasoning of the Dudley case, heavily relied upon below, marks a significant departure from the majority rule presently governing bank set off rights in bankruptcy proceedings and should not be followed in this Circuit. As the dissent in Dudley rightly pointed out, adoption of that rule "will in the long run have serious injurious effect on banking and business practices." Id., at 403. (Dissent of Pope J.).

The traditional rule, but recently reaffirmed by this court in Katz v. First National Bank of Glen Head, No. 76-7577, CCH Bankruptcy Rptr., ¶66,566, p. 76,502 (2nd Cir. 1977), permits a bank to set off deposits which are accepted in good faith and in the regular course of the bank's business.

In Katz, the trustee sued the bank to recover monies on deposit with the bank which the bank had set off

against indebtedness due it before bankruptcy. The trustee claimed that the bank's set off constituted a voidable preference under §60 of the Bankruptcy Act. The District Court granted summary judgment to the bank on the ground that the bank had properly set off these monies on deposit in the bankrupt's account in conformance with §68 of the Act, which set off, it said, did not constitute a "transfer" within the meaning of §60 of the Act.

This Court reversed and remanded the case for a new trial. Before deciding whether the bank's set off was a "transfer" within the meaning of §60 of the Act, the District Court was instructed to determine from all the circumstances, whether the deposits were made in the regular course of business of both the bankrupt and the bank. Thus, the Court said:

"In deciding whether a bank's set-off is a transfer, a court must determine from all the circumstances whether the deposits were made in the regular course of business. In view of the purpose of the inquiry, it does not make sense to consider only the bank's course of business. If the deposits somehow are out of the regular course of the depositor's business, the bank's normal

procedures, or the usual course of dealings between the depositor and the bank, then an inference can be drawn that the deposits were not ordinary deposits but served to transfer the depositor's property to the bank." Id., at p. 76,506.

The court in Katz was particularly mindful of the long line of authority and practical considerations for maintaining the traditional rule which, absent compelling reasons, should not be disturbed. There the Court said:

"...[W]e are mindful of the traditional rule that in order to prove a voidable preference the trustee must show complicity or understanding on the part of the bank. This is in accordance with a long line of authority that a bank is entitled to set-off deposits which were accepted in good faith and in the regular course of the bank's business. This rule in turn is premised on practical commercial considerations; it has survived the test of time; and, absent compelling reasons for doing so, it should not be disturbed." Id., at p. 76,503.

Banks are presumptively permitted to exercise set off rights against general accounts in the absence of extraordinary showing sufficient to invoke the court's discretion to deny set off. Pepper v. Litton, 308 U.S. 295 (1939); Farmer's Bank of Clinton, Missouri v. Julian, 383 F.2d 314 (8th Cir. 1967) (Cited with approval in Katz, supra).^{6/}

^{6/} See Judge Babitt's findings, footnote 8 on page 62 of this brief.

The rationale of the traditional rule is well settled, as the Court said in Katz:

"It is well settled that deposits in an unrestricted checking account, made in the regular course of business, do not constitute transfers within the meaning of the Bankruptcy Act.* The theory of these cases is that a deposit creates a debt owed to the depositor by the bank and does not constitute a parting with property by the depositor."* [Numerous citations omitted]. Supra, at p. 76,505.

The crucial test is whether the dealings between the bank and the bankrupt were "outside the regular course of the bank's business or the result of complicity between the bank and the bankrupt." Katz, supra, at p. 76,505, n.6.

The facts in the instant matter are the same as in Katz. Here, as there, the trustee seeks to recover monies set off by the bank based on theories of voidable preference. Here, as there, the court below improperly applied the wrong test to determine whether a "voidable transfer" had taken place. Here, as there, this case should be remanded for a new trial with proper findings based on the application of the traditional rule reaffirmed in Katz.

As stated above, in the absence of fraud or collusion between a bank and a depositor, a bank may set off

the balance in a general account against any indebtedness owed by the depositor. Farmers Bank of Clinton, Missouri v. Julian, supra. While a bankruptcy court is vested with the equitable power to subordinate claims and deny set offs, this power should not be applied punitively to take away rights to which a creditor is justly entitled to, or benefit other creditors who have no entitlement. Id., at 323.

To sustain a determination of fraud or collusion sufficient for the exercise of discretion to deny set off, the court in Farmers Bank required a finding that the bank account had been "built up" for the purpose of permitting that bank to obtain a preference by way of setting off the account of the bankrupt. Id., at 324; Katz, supra.

The record below is devoid of any evidence that the 1970 Agreement which established the Account was the result of fraud or collusion sufficient to deny Bank its right of set off. The 1970 Agreement was negotiated by ALC, Bank and other sophisticated banks and equipment lessors well acquainted with financial workout situations. (A-404). Negotiations took place over a seven month period. (A-288). The 1970 Agreement is a comprehensive

agreement setting forth the rights and obligations of the parties to the Agreement. The 1970 Agreement clearly distinguished between the Account to be maintained at Bank by ALC and ALC's obligations to Bank and the other banking and equipment leasing creditors. (A-409). There is no evidence in the record that at the time of the 1970 Agreement, Bank or any other creditor sat on ALC's board of directors or in any way controlled the internal working affairs of ALC.

While the 1971 Agreement called for a special account into which 50% of the cash flow was to be deposited to pay the "close-out debt," the Minutes of the August 29, 1972 ALC board of directors meeting, indicates that this requirement was waived at the August 29, 1972 meeting which was attended by all the other banking and equipment lessor creditors. In lieu of the special account, payments due under the 1971 Agreement were to be paid directly to the creditors. (A-395). Neither before nor after the 1970 Agreement did the Bank control ALC and at no time did Bank have more than one representative on the board of directors of ALC. (A-393).

The Dudley rule, which is not mentioned in the Katz decision, has never been the law in this Circuit. Therefore, that rule, if now approved in this Circuit, would deny banks set off rights based upon bankruptcy judges' notions of abstract non-specific "equitable considerations," without the necessity of showing the elements of the traditional rule that any fraud, collusion or bad faith had taken place in the build up of the account. Katz, supra.

Without doubt, the Dudley rule will have a chilling effect on banks who might otherwise work closely with insolvent debtors to arrange "out of court" settlements of their financial problems. First National Bank of Portland v. Dudley, supra, at 403. (Dissent of Pope J.). As a matter of policy, this court should not disturb the rights of Bank which have vested in reliance upon the comprehensive 1970 and 1971 Agreements. The purpose of these Agreements was twofold, to keep ALC in business and to pay all trade creditors, employees and taxes "100 cents on the dollar." (A-156, 185). The parties to the Agreements were other large banks and sophisticated equipment lessors. (A-404). Bank bargained for its right to set off against

the Account by the provision in the 1970 Agreement requiring the Account to be maintained with it. (A-409). No creditor has ever protested Bank's right to set off against the Account. As a result of the Agreements, ALC was able to continue in business for three years, and all trade creditors, employees and taxes have been paid "100 cents on the dollar." (A-156, 185). Invoking judicially created "equitable" considerations to reform these Agreements, will result in the unwillingness of banks and other lenders in the future to enter into agreements of this nature whose beneficial effect is manifest by the results of these Agreements in this case.

As Judge Van Graafeiland rightly pointed out in his dissent in Katz:

"The facts of financial life are such, however, that the businessman seeking credit is most likely to secure it at the bank where he is a depositor.... If a businessman's efforts to create and maintain an adequate balance are, standing alone, to be construed as transfers of the funds involved, an inducement for the bank to work along with the financially troubled entrepreneur is removed. It was to encourage such cooperation that the bank's right of setoff was preserved when the Bank-

ruptcy Law was amended by the Chandler Act in 1938. See 4 Collier on Bankruptcy, §68.01(3). A right which Congress has refused to eliminate should not be eliminated by this Court in its stead." Id., at pp. 76,508, 76,509.

The specific right of Bank to set off as set forth in §68 of the Act was specifically designed to avoid such a result. When the Chandler Act was introduced in its original form in 1936, there were three additional subdivisions in §68 including a subdivision dealing specifically with set off of deposits by banks. 4 Collier on Bankruptcy, (14th Ed. 1975) §68.01, p. 845. The legislative history of §68 clearly shows that the proposed new sections of §68 dealing specifically with bank deposits and set offs was intended to limit the bank's right of set off after it had learned that a depositor was insolvent. Id. It is stated by the editors of Colliers that:

"Banks and banking associations, on the other hand, felt there was a difference between the extension of bank credit and the extension of ordinary commercial credit, and that unless the bank was able with some degree of safety to carry a depositor after it had learned of his financial difficulties, many customer depositors were driven into bankruptcy, who might otherwise extricate themselves from their financial difficulties." Id., at p. 843.

The extract of the House hearings on the proposed amendments to §68 contain a rather lengthy illustration of the reason why §68 was improperly applied in the case at bar. Id., at p. 846, n.18. The substance of the hypothetical situation outlined above is that banks are frequently called upon to work with businesses which are in financial difficulty. Crucial to the survival of such businesses is the willingness of banks to forego an immediate set off of the borrower's balance. When a bank is willing to continue to maintain a banking relationship with a business in financial trouble, the ultimate result will hopefully be that the borrower is able to extricate itself from its financial difficulties. Such a result should be encouraged by the Bankruptcy Act. Under such circumstances a bank should not be prejudiced by its continuing to permit the business to make withdrawals and deposits, particularly when the bank is providing financial support to the business.

An example of such a situation occurred in Studley v. Boylston Bank, supra, where a company's usual banker learned of its insolvency and continued to make loans and

charged the company's deposit account when notes came due. Subsequently, a bankruptcy trustee attempted to recover payments on the notes as voidable preferences. The court, in denying recovery to the trustee, stated:

"The Bankruptcy Act contemplates that by remaining in business and at work an insolvent may become able to pay off his debts. It does not prevent him from continuing in trade, depositing money in a bank, drawing checks and paying debts as they mature, either to his own bank or any other creditor." 229 U.S., at 526.

Bank submits that the opinions of the courts below will substantially hinder all banks who desire to work closely with insolvent debtors who are trying to arrange for an "out of court" compromise or settlement of their financial problems.

The bankruptcy court below emphasized the provision in the 1970 Agreement requiring ALC to conduct all of its banking through Bank. The court seemed to feel that this provision was unusual; however, to the contrary, such a provision is not uncommon. In Katz, supra, the court noted the usual practice of the bank there in requiring borrowers to open a general checking account with it, supra, at p. 76,504.

In Goggin v. Bank of America National Trust & Savings Association, 183 F.2d 322, 324 (9th Cir. 1950), cert. den., 340 U.S. 877 (1950), a case dealing with the California codification of the banker's lien, the court observed that as part of the sizeable lending transactions between the Bank of America National Trust & Savings Association and the bankrupt, that "there was apparently an implied understanding between the Bank of America and the debtor corporation, that all of the usual banking transactions would be handled through the Bank of America." As pointed out in a footnote to the opinion, there were deviations from that agreement, but those deviations were minor and only for reasons of convenience with the knowledge and consent of the bank. Goggin, 183 F.2d, at 324, n.1.

The court in Goggin reviewed the law merchant from which the banker's lien under the common law had evolved.^{7/} The mercantile theory, as stated in Goodwin v. Barre Savings Bank and Trust Co., 91 Vermont 228, 100 A. 34, 37 (1917) is that:

"The theory of the law is that a bank extends credit and accommodations to its customer in reliance upon the expectation

^{7/} The bank's traditional right of set off was recognized in antiquity by Roman law since the time of Gaius under the rule of "compensatio." THE DEVELOPMENT OF SET-OFF, 64 U. Pa. L. Rev. 541 (1916).

that such paper will, from time to time, come into its possession and become available to it as security or offset."

And as was stated in Citizens Bank & Trust Co. v. Yantis, 287 S.W. 505, 507-508 (Tex. Civ. App. 1926):

"This doctrine [the banker's lien] is not dependent solely upon any express agreement, but arises by implication growing out of the relationship of the depositor and the bank. It is a whole-some rule, and presupposes that for such accommodations it will stand charge with a lien upon the proceeds. *** Since the lien is given upon the theory that any credit the bank extends to its customer by way of loan or overdraft is given on the faith that money or security sufficient to meet the debt at its maturity will come into the possession of the bank to discharge the same, of course, in such a case no express agreement is necessary."

In Goggin, the court also rejected the receivers' argument that the bank was not entitled to a lien unless it had written a lien provision into its lending agreement, recognizing that parties to commercial loan transactions have expectations, one of which is that a deposit account will be maintained with the lender. Tyler v. Marine Midland Trust Co. of New York, 128 F.2d 927, 928 (2nd Cir. 1942).

From September 15, 1970 to March 27, 1975, the date when ALC filed its petition for an arrangement, ALC maintained usual and ordinary banking relations with Bank. As testified to at the trial, the deposits in Bank, including the funds on deposit in the form of certificates, represented the general receipts taken in by ALC over a lengthy period of time. (A-311).

The deposits made by ALC with Bank were drawn upon, and were renewed from time to time over the period of two or three years. During this course of time ALC continued to operate its business and continued to deal with creditors in the ordinary fashion. In no sense could it be said that ALC was engaged in the liquidation or closing down of its business. Rather, every fact indicates that ALC was actively pursuing its business and had every expectation of remaining a viable entity.

To deprive Bank of its right of set off will adversely affect the willingness of all banks to aid financially distressed debtors.

The potential effect of the rule articulated in Dudley on the willingness of lenders in the future to enter

into agreements of this nature did not go unnoticed in Dudley.

Judge Pope, in his dissent, aptly stated that:

"The type of arrangement here attempted was designed to accomplish a useful object, - to get a faltering business on its feet, all to the end that ultimately all creditors may be paid, and the owner save his business. True, the attempt failed, but it was worth the try. Such attempts, I think, should be encouraged. But from now on no bank, creditor of such a debtor, will dare to agree to 'go along,' on such a plan, because if it should fail, and bankruptcy follow, as here, the bank would risk being held to have waived its right of set-off." Supra, at 404.

The adverse effect of the decisions below is magnified by the fact of its being based on unpleaded equitable principles without requisite subsidiary findings of fact.

The manner in which the courts below invoked Pepper v. Litton, supra, and Bank of Marin v. England, 389 U.S. 99, 103 (1966), in their zeal to promote "equality among creditors," (A-477, 498), to bring about the instant forfeiture is contrary to the recently articulated philosophy of the Supreme Court in United States Trust Co. v. New Jersey, U.S. , 52 L.Ed.2d 92 (1977). In U.S.

Trust, the Court upheld the principle of protecting the "reasonable expectations" of secured creditors. U.S. Trust marks the beginning of a reappraisal of rights of creditors by our appellate courts.

In U.S. Trust, the Supreme Court struck down statutes enacted by the legislatures of both New York and New Jersey to repeal "a statutory covenant made by the two states in 1962 that had limited the ability of the Port Authority of New York and New Jersey to subsidize rail transportation from revenues and reserves." Id., at 92. Although grounded on the Contract Clause of the U.S. Constitution, the Court expressed great concern over the tendency to balance away private loss because of public benefit by disappointing the expectations of secured creditors. Id., at 114.

The record shows that all the 1970 Agreement Creditors were at all times aware of the facts and did consent to the 1970 Agreement, including the provisions

which established the Account. (A-371, 372). Since Bank was the largest creditor, its insistence upon maintenance of the Account at its facilities did no more than reflect its bargaining position vis-a-vis the other creditors who agreed to the 1970 Agreement repayment schedule. These other creditors received the benefits of the 1970 Agreement and are estopped from denying Bank its set off rights against the Account. Federal Power Commission v. Colorado Interstate Gas Co., 348 U.S. 492 (1955); Gateway Nat'l Bank v. Saxe Bacon & Bolan, 40 A.D.2d 653, 336 N.Y.S.2d 668 (1st Dept. 1972).

POINT III

BANK IS ENTITLED TO APPLY THE MONEY AND
CERTIFICATES OF DEPOSIT IN WHICH IT
PERFECTED A SECURITY INTEREST BY
POSSESSION TO SATISFY THE 1970 \$100,000.00
AGREEMENT LOAN WHICH WAS SECURED BY ALL
ALC'S UNENCUMBERED ASSETS

Under the terms of the 1970 Agreement, the \$100,000.00 loan to ALC was to be secured by all the unencumbered assets of ALC. (A-417). ALC perfected its security interest in money and certificates of deposit of ALC held in the Account by possession, as required by Section 9.304 of the Uniform Commercial Code enacted in New Jersey. N.J. Stat. Ann. Sec. 12A:9.304 (West). See, Southvie Corp. v. Kleberg First National Bank, 512 S.W.2d 817 (Tex. Civ. App. 1974), where the court held that a certificate of deposit was deemed to be an "instrument" for purposes of perfection of security interest by possession under the Uniform Commercial Code.

At trial, counsel for ALC conceded that Bank would be entitled to retain \$100,000.00 in the Account in the event ALC prevailed on its counterclaims. (A-276).

Moreover, the bankruptcy judge never made sufficient findings of fact on this issue to satisfy the requirements of Bankruptcy Rule 752. The court never identified why the "unencumbered assets" did not include money and certificates perfected by Bank's possession.

The purpose of Bankruptcy Rule 752 is, in part, to ensure that the reviewing court is informed of the basis of the lower court's decision. The findings of the bankruptcy court must be sufficient to allow the reviewing court a clear understanding of the basis of the bankruptcy judge's decision. In re D.H. Overmyer, 510 F.2d 329 (2nd Cir. 1975).

Bankruptcy Rule 752(a) is applicable to the instant adversary proceeding which was tried before the court below without jury. Rule 752(a) requires, in pertinent part, that: "the court shall find the facts specially and state separately its conclusions of law thereon." Rule 752(a) further states that if a "memorandum decision is filed, it will be sufficient if the findings of fact and conclusions of law appear therein."

As set forth in the Advisory Committee Notes, Bankruptcy Rule 752 is an adaptation of FED.R.CIV.P.52. One reason for requiring clear and complete findings of fact with respect to the issues raised in an adversary proceeding is to sufficiently perfect the record so it can be reviewed on appeal without the necessity of having the bankruptcy judge make additional findings of fact.

See, e.g., In re Ulrico Development, 311 F.Supp. 1393, 1394 (D. P.R. 1972), where this problem arose.

Similarly, the bankruptcy court below refers to a set off by Bank of proceeds of a certificate of deposit, a portion of the proceeds of which "was used to pay New Jersey State taxes." (A-468). The opinion omits a finding of fact that this particular certificate of deposit had been assigned to plaintiff by ALC by written instrument of assignment, dated November 1, 1974, as a condition to plaintiff issuing an irrevocable letter of credit in connection with the sales tax claim against ALC by the Division of Taxation of the New Jersey Treasury Department. This assignment was introduced at trial as Exhibit "7." (A-399).

POINT IV

THE BANK WAS DENIED PROCEDURAL DUE PROCESS
IN THAT IT RECEIVED NO NOTICE OF ANY KIND
THAT A CAUSE OF ACTION BASED ON AN ESTOPPEL
WOULD BE ASSERTED AGAINST IT AND WAS DENIED
AN OPPORTUNITY TO INTRODUCE EVIDENCE ON THE
ISSUE OF ESTOPPEL

All the elements of an estoppel must be affirmatively pleaded with particularity and certainty. Coen v. American Surety Co., 120 F.2d 393 (8th Cir. 1941). This is true whether estoppel is pleaded as a defense or as an element of a cause of action. Pope v. City of Atlanta, 418 F.Supp. 665, 667 (N.D. Ga. 1976). See, collected authorities in 31 C.J.S. Estoppel, §153(1).

In Pope v. City of Atlanta, the plaintiff's complaint was dismissed for failure to properly plead an estoppel, the court stating the general principle that:

"Estoppel must be pleaded with particularity and certainty... (N)othing can be supplied by inference or intendment, it will be against and not in favor of the estoppel...."
Citing Coen v. American Surety Co., 120 F.2d 393 (8th Cir. 1941).

FED.R.CIV.P. 8(c), as adopted by Bankruptcy Rule 708 of the Federal Rules of Bankruptcy Procedure requires that a party shall set forth affirmatively certain affirmative defenses," including the defense of estoppel. By failing to plead estoppel, this defendant has waived it as an affirmative defense. Hatridge v. Aetna Cas. & Sur. Co., 415 F.2d 809 (8th Cir. 1969); Glen Falls Ins. Co. v.

Newton Lumber & Mfg. Co., 388 F.2d 66 (10th Cir. 1967);
U.S. v. Anthony, 231 F.Supp. 414, 416 (S.D. Iowa 1964).
See also, 2A Moore's Federal Practice (2d Ed. 1975),
¶8.27(3), at p. 1853.

Bank did not receive "good and explicit notice" that the issue of estoppel would be raised by ALC. (A-83-93). The only testimony allegedly related to the issue of estoppel was brought out by ALC counsel on cross examination at the very end of the trial. (A-371,372). Bank was denied an opportunity to present competent evidence from the actual parties who negotiated the 1970 Agreement, which evidence would have conclusively shown that Bank made no misrepresentations concerning the general nature of the Account.

Bank was therefore denied procedural due process, in that it received no notice that an estoppel defense or a counterclaim would be raised and was, therefore, denied the opportunity to introduce evidence on that issue. Blonder-Tongue Labs v. University Foundation, 402 U.S. 313 (1971).

In Blonder-Tongue, the court created a new rule on the availability of collateral estoppel defense in

patent infringement actions. Neither party in that case had argued the issue at trial or on appeal. The Court remanded the case to give plaintiff an opportunity to offer evidence why estoppel should not be imposed. Thus, the Court in Blonder-Tongue, commenting on the failure of the defendant to plead the affirmative defense of estoppel, said:

"The purpose of such pleading is to give the opposing party notice of the plea of estoppel and a chance to argue, if he can, why the imposition of an estoppel would be inappropriate."
Id., at 350.

The distinction between pleading that the Account was a trust account established for the benefit of the creditors including ALC and pleading that Bank by its conduct is estopped from asserting its traditional set off against a general account is "not fine", as the District Court asserted, but fundamental. (A-501). In the former case, ALC need only show that the account was established as a special trust account for the benefit of all creditors and ALC, but in the latter case, ALC must prove the elements of estoppel sufficient to deny Bank set off

right it otherwise would have against a general account. The fact that Bank had no opportunity to introduce evidence with respect to the question of estoppel, requires that the order appealed from be reversed or remanded for further hearing on the issue of estoppel.

POINT V

NEITHER THE FINDINGS OF FACT MADE BY THE BANKRUPTCY COURT BELOW NOR THE RECORD OF THE PROCEEDINGS BELOW TAKEN AS A WHOLE SUPPORT THE CONCLUSION THAT BANK WAS ESTOPPED TO ASSERT THE RIGHT OF SET OFF. THE UNDISPUTED FACTS AS CONTAINED IN THE RECORD REQUIRE A REVERSAL OF THE DECISION OF THE COURTS BELOW AND ENTRY OF JUDGMENT IN FAVOR OF BANK

The courts below based their decision on the concept of equitable estoppel. The Agreements specifically provide that New Jersey law applies. (A-430); (A-79).

The controlling law of the State of New Jersey is that estoppel is an equitable doctrine, the essential elements of which as related to the party estopped are: (1) conduct which amounts to false representation or concealment of material facts or at least which is calculated to convey

an impression that facts are otherwise than and inconsistent with those which the party subsequently attempts to assert; (2) an intention or expectation that such conduct shall be acted upon by the other party. Fidelity Union Trust Co. v. Essex County Mortgage Co., 130 N.J. Eq. 351, 22 A.2d 296 (App. & Errors, 1941); (3) actual or constructive knowledge of the real facts; and (4) party to be estopped is taking an inconsistent position. Seire v. Police & Fire Pension Commission of Orange, 4 N.J. Super. 230, 66 A.2d 746 (App. Div. 1949).

The essential elements as related to the party claiming the estoppel are: (1) lack of knowledge and of the means of acquiring the truth as to the facts in question. Lawes v. Lynch, 6 N.J. 1, 76 A.2d 885 (1950); (2) justifiable and unequivocally referable reliance on the conduct of the party estopped. Burns v. McCormick, 233 N.Y. 230 (1920); Philo Smith & Co., Inc. v. U.S. Life Corp., 420 F.Supp. 1266 (S.D.N.Y. 1976); and (3) action based thereon of such character as to materially change his position prejudicially. See generally, U.S. v. Aetna Casualty and Surety Co., 480 F.2d 1095 (8th Cir. 1973); Parker v.

Sager, 174 F.2d 657 (4th Cir. 1949); 28 Am.Jur.2d, Estoppel & Waiver, §35 (1966). See also, Brown v. New York Life Insurance Company, 59 F.Supp. 721 (D.N.J.), aff'd, 148 F.2d 524 (2nd Cir. 1945).

There was a total failure to prove any of the requisite elements of estoppel against Bank. The failure to prove even one of the requisite elements is sufficient to prevent the finding of an estoppel. Brown v. New York Life Insurance Company, supra.

The facts adduced at trial show that:

1. Bank made no misrepresentation and concealed no facts as to its right of set off. (A-371,372). The absence of a misrepresentation or concealment precludes the finding of an estoppel. Trenton Banking Co. v. Howard, 187 A.569, aff'd, 121 N.J. Eq. 85, 187 A.575 (Ch. Div. 1936).

2. Each of the creditors had full knowledge of all facts or the means of acquiring knowledge of all the facts in question, thereby precluding the finding of an estoppel.

3. Bank did not induce any creditor or party to take any action or to refrain from taking any action. The

major creditors were sophisticated equipment leasing or financial institutions who had full knowledge of all facts. (A-404)(A-61). "There can be no estoppel as to facts equally known to both parties or as to facts which the party invoking the estoppel ought, in the exercise of reasonable prudence, to know. Kenneally v. First National Bank of Anoka, 400 F.2d 838, 843 (8th Cir. 1968).

4. There is no evidence that any creditor changed its position in reliance on conduct or statements of Bank. Reliance is an essential element, without which there can be no estoppel. Ginsburg v. Eastern Life Ins. Co. of New York, 118 N.J. Eq. 223, 178 A.378, aff'd, 120 N.J. Eq. 110, 184 A.348 (Ch. 1935); Helvering v. Schine Chain Theatres, 121 F.2d 948 (2nd Cir. 1941).

5. The failure of some unidentified creditor to "attach" property of ALC as referred to by the bankruptcy court below cannot constitute reliance, because the signatory creditors to the agreements voluntarily and intentionally relinquished known rights, including the right to commence a lawsuit and attach the property of ALC. The Agreements recognized that other creditors could and might still seek to attach property of ALC. (A-425).

There is no showing or finding of fact that the hypothetical attaching creditor had a right to rely on anything done by Bank.

6. No evidence was offered to establish that any creditor relied on the alleged misrepresentations of Bank or that any creditor or ALC thought that Bank had relinquished its right of set off. The failure to produce a creditor witness permits the inference that the testimony of such a creditor would have been unfavorable to the defendant. Midland Enterprises, Inc. v. Notre Dame Fleet & Towing Service, Inc., 538 F.2d 1356 (8th Cir. 1976). Such an inference should be more readily indulged when the creditors are sophisticated corporate parties readily available to testify.

7. Bank did not mislead any creditor. In fact, the only evidence establishes that Bank clearly stated to certain creditors who inquired of it that it had a right of set off with respect to any matured note. See Point I, supra.

8. At all times the conduct of Bank was consistent with the retention by it of the right of set off and

the statements made by it with respect to the retention of that right.

The memorandum opinion of Judge Babitt implied that Bank should be estopped from asserting its right of set off because it had remained silent and had not apprised the other parties to the agreement that it was its opinion that it continued to have the right of set off. (A-476).

The law is clear that for Bank to be charged with estoppel by silence, it must have had a duty to speak or must have known that the party seeking to assert the estoppel was acting under a mistaken belief. Bush v. Remington Rand, 213 F.2d 456 (2nd Cir. 1954). An agreement must be clear and specific to deprive a party of the ordinary right of set off. Udike v. Oakland Motor Car Co., 53 F.2d 369, 373 (2nd Cir. 1931).

Assuming that Bank had a duty of disclosure it complied with that duty by stating its position that it had the right to set off only against matured notes of ALC. (A-371,372). Bush v. Remington Rand, supra.

In addition, the 1971 Agreement contained a specific provision directed toward preventing the kind of

inadvertent loss of rights found by the courts below, namely, that nothing in the 1970 or 1971 Agreements was intended to affect any security interest held by any bank or lessor. (A-72). Such a provision is substantial evidence that the right of set off of all banks was intended to survive. It is submitted that a full trial of the issue of estoppel would disclose that other signatory banks exercised the right of set off.

There was no evidence introduced at trial to show that ALC or any creditor was ignorant of the right of set off of Bank or that ALC or any creditor was acting under mistaken belief or that ALC or any creditor relied on the alleged "silence" of Bank. The burden was on the defendant to prove all the elements of an estoppel, including, a misrepresentation (even if by silence) and to prove reliance unequivocally referable to the misrepresentation. Lawes v. Lynch, supra. The failure to prove these elements, among others, compels a reversal of the judgment below as a matter of law.

POINT VI

THE ORDER DATED MARCH 1, 1977 DOES NOT
CONFORM WITH THE MEMORANDUM OPINION
DATED DECEMBER 9, 1976

A.

Assuming, arguendo, that the findings of fact and record below supported the conclusions of law of Judge Babitt, then it would be necessary to consider the court's order of March 1, 1977, which grants judgment to the trustee.

In substance, the bankruptcy court below impressed a constructive trust on the otherwise general Account^{8/} on equitable estoppel grounds because of Bank's alleged conduct or misrepresentations which were allegedly relied upon by the 1970 Agreement signatories when the Account was set up. (A-476). A constructive trust so impressed on the Account can only operate in favor of the 1970 Agreement Creditors, not "all ALC's creditors," if they detrimentally relied on Bank's alleged misrepresentations. The other creditors neither forbore any obligations due them, nor in any way

^{8/} Judge Babitt held, at pp. 12-13, that: "While the funds raised pursuant to the 1970 and 1971 agreements and deposited to ALC's bank account and subject to its check for general purposes may not be said to come within the accepted definition of a special deposit so as to be insulated from the plaintiff's right of set off

relied on Bank's conduct or representations. The concept of constructive trust is discussed in Empire Stevedoring Co. v. Oceanic Adj. Ltd., F.Supp. 921, 925 (S.D.N.Y. 1970); and 4A Collier on Bankruptcy, (14th Ed. 1975) §70.25[1]P.348. Surely, ALC cannot contend that the establishment of the Account under the control of its principal creditor, Bank, was for ALC's benefit.

It is well established that a constructive trust imposed for the benefit of specified creditors is not property of the bankrupt's estate. In re Prudence Bonds Corp., 79 F.2d 212 (2nd Cir. 1935); Empire Stevedoring Co. v. Oceanic Adj. Ltd., supra; 4A Collier §70.25. Thus, the impressing of a constructive trust on the Account for the benefit of the 1970 Agreement Creditors entitles only those creditors to the benefits of the trust and not ALC.

Therefore, since any controversy over the Account does not involve ALC, the bankrupt, the court below erred in not dismissing ALC's counterclaims for lack of subject matter jurisdiction. First State Bank & Trust Co., Guthrie, Okla. v. Sand Springs State Bank, 528 F.2d 350 (10th Cir.

1976); Baker Taylor Drilling Co. v. Stafford, 369 F.2d 551 (9th Cir. 1966); In re Love B. Woods & Co., 222 F.Supp. 161 (S.D.N.Y. 1963); In re Dutchess Processing Co., Inc., 2 Bankr. Ct. Dec. 912 (S.D.N.Y. 1976). (Babitt, J.).

As the court in First State Bank said:

"A court of bankruptcy cannot entertain jurisdiction of a private controversy which does not relate to matters pertaining to bankruptcy. Associated Electronic Supply Co. of Omaha v. C.B.S. Electronic Sales Corporation, 288 F.2d 683 (8th Cir. 1961). In the same vein, a bankruptcy court lacks jurisdiction of a controversy solely and exclusively between third parties which does not involve, directly or indirectly, the bankrupt or its property, Central States Corp. v. Luther, 215 F.2d 38 (10th Cir. 1954); O'Dell, supra." Id., at 353.

In Mid-Jersey National Bank v. Fidelity Mortgage Investors, 518 F.2d 640 (3rd Cir. 1975), the court carefully restricted the power of a bankruptcy court to those matters, "necessary for the federal courts' appropriate control and disposition of the [bankrupt's] property." Id., at 643. Therefore, the court's lack of subject matter jurisdiction over ALC's counterclaims is apparent. The counterclaims should be dismissed.

B.

Judges Babitt and Goettel gave no legal conclusions for refusing to honor Bank's set offs, other than general equitable considerations; such considerations are not sufficient. In the absence of fraud, accident or mistake a court of equity cannot change the terms of a contract. Hedges v. Dixon County, 150 U.S. 182 (1893). The conditions under which a bankruptcy court, as a court of equity, may invoke equitable principles, are set forth in Manufacturers Finance Co. v. McKey, 294 U.S. 442, 448 (1935):

"The mere fact that a party is obliged to go into a federal court of equity to enforce an essentially legal right arising upon a contract valid and unassailable under controlling state law does not authorize that court to modify or ignore the terms of the legal obligation upon the claim, or because the court thinks, that these terms are harsh or oppressive or unreasonable. A party may stand upon the terms of a valid contract in a court of equity as he may in a court of law. If he asks no favor, he need grant none." 294 U.S. 448-449.

In In re Advance Printing & Litho Co., 277 F.Supp. 101 (W.D. Pa. 1967), aff'd, 387 F.2d 952 (3rd Cir. 1967), the Hedges and Manufacturers' Finance Co. decisions were

followed, as requiring a court to uphold the inviolability of a contract attacked by a trustee in bankruptcy. In doing so, the court said that a valid contract cannot be altered by the court's own notions of reasonableness and fairness. The court stated that:

"This court recognizes that the result reached here appears inequitable and even unconscionable so far as the unsecured general creditors are concerned, but it is believed that the result is compelled by the authoritative Appellate Court decisions." 277 F.Supp. at 105.

The holding of In re Four Seasons Manufacturing Centers of America, Inc., 483 F.2d 599 (10th Cir. 1973), also followed the Hedges and the Manufacturers' Finance Co. decisions in agreeing that, absent fraud, accident or mistake, a court of equity cannot change the terms of a contract. The court held that:

"Neither the Special Master nor the Trial Court could, under the circumstances, substitute their interpretation of the contract for that of the contracting parties, and, finally, the claim cannot be disallowed on equitable grounds where there are no operative facts which would justify application of any equitable principle to defeat an otherwise lawful claim." 483 F.2d at 603.

See, In re Continental Vending Machine Co., 491 F.2d 813 (2nd Cir. 1974), where the Second Circuit held that the District Court could not alter the written terms of a contract between a court appointed conservator and a secured party. Similarly, in Winner Corporation v. H. A. Caesar & Co., Inc., 511 F.2d 1010 (6th Cir. 1975), the court held that a bankruptcy judge could not alter the written terms of a contract between a debtor and a secured party.

The written assignment and the set off agreement contained in the note from ALC to Bank are clear, unequivocal and valid. Where a Bank set off an account against a note due it and there was a written agreement assigning the account as security for the payment of the note, the written agreement was binding and the set off was authorized. Georgia Bank & Trust Company v. Hadarits, 143 S.E.2d 627, 221 Ga. 125 (S. Ct. Ga. 1965).

Under the circumstances, it should be held as a matter of law that Bank was entitled to set off the balance of the certificate and the Account against any amount due to Bank from ALC and the judgment of the court below should be reversed.

CONCLUSION

For all of the foregoing reasons, the order appealed from should be reversed with respect to the "Counterclaims" of ALC and Bank should be granted all the relief requested in its complaint.

Dated: New York, New York
December 23, 1977

Respectfully submitted,

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